ENTERPRISE OPERATIONS

Nature and Purpose:

Enterprise Funds are used to account for operations (a) that are financed and operated in a manner similar to private business enterprises--where the intent of the governing body is that the costs (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges; or (b) where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes. Services accounted for in Enterprise Funds are tangible, and it is possible to determine the extent to which they benefit individual service consumers.

Services financed primarily by user charges should generally be accounted for in Enterprise Funds. Municipalities providing such services must decide whether they want to recover all, some, or none of the costs of providing them through user charges. This is a policy decision that should not be confused with the decision to account for the service as an Enterprise Fund or in governmental fund types. A government is not required to finance any particular percentage of the cost of providing a particular service through user charges simply because it accounts for it as an Enterprise Fund.

Governments should establish a policy that defines operating revenues and expenses that is appropriate to the nature of the activity being reported, disclosed it in the summary of significant accounting policies, and use it consistently from period to period. A consideration for defining a proprietary fund's operating revenues and expenses is how individual transactions would be categorized for purposes of preparing a statement of cash flows. Transactions for which cash flows are reported as capital and related financing activities, noncapital financing activities, or investing activities normally would not be reported as components of operating income. This includes most revenues considered to be nonexchange and exchange-like, such as tax revenues and in some cases fees and charges.

Enterprise Fund accounting is designed to accumulate the total cost (including depreciation) of providing a particular service and to indicate the extent to which user charges imposed upon service consumers are sufficient to cover those costs. When a government elects not to fully recover the total cost of providing a service through user charges, Enterprise Fund accounting indicates the amount of subsidy for the service which must be financed from taxes or other sources. Once a decision is made to account for a particular service as an Enterprise Fund or in governmental fund types, it should be followed consistently from year to year. Governmental fund type and proprietary fund type accounting produce significantly different financial statements. Fund classifications must be consistently applied from year to year if there is to be a significant potential for meaningful interperiod financial statement comparative analysis.

Number of Funds:

Individual enterprise services must ordinarily be accounted for in separate Enterprise Funds. Such segregation is essential to: (1) determining the total cost of providing a service and the extent to which user charges cover that cost; and (2) assuring that the resources of one enterprise are not illegally or improperly utilized by another.

Most Enterprise Funds engage in transactions with other funds of their municipality. If Enterprise Fund financial statements are to be comparable with financial statements of businesses providing similar services, interfund transactions which would be treated as revenues or expenses if they involved parties external to the government (quasi-external interfund transactions) must be priced and accounted for as if they did involve such parties. Examples of Enterprise Fund quasi-external interfund transactions include: (1) Water Enterprise Fund charges to the General Fund for water used; (2) Data Processing Internal Service Fund charges to an Enterprise Fund for data processing services rendered; and (3) General Fund charges to an Enterprise Fund for payments in lieu of taxes that would have been levied on its property if it were a business enterprise.

Relationship to Budget:

Sound financial administration requires the preparation and adoption of a comprehensive annual operating budget for the entire government including each of its Enterprise Funds. Budgets are necessary to help assure that: (1) service objectives are attained; (2) expenditures are properly controlled; and (3) adequate resources will be available to finance current operations, repay long-term liabilities, and meet capital outlay requirements.

Enterprise Fund service delivery levels are determined by the extent of consumer demand. Increased service delivery levels increase expenses, but also result in higher revenues. Because Enterprise Fund revenues and expenses fluctuate with changing service delivery levels, the use of fixed dollar budgets is generally considered inappropriate for them.

Flexible budgets are generally used for Enterprise Fund planning, control, and evaluation purposes. Such budgets include estimated revenues and expenses for each of several different service delivery levels. Flexible budgets permit comparisons of actual results of operations with appropriate budgeted amounts for whichever level of activity is actually experienced during a period. Budgetary accounts are ordinarily not formally integrated into Enterprise Fund general ledgers.

GAAP financial reports need not include budgetary comparisons for Enterprise Funds. Nevertheless, many governments include such comparisons as supplementary data in their reports.

Accounting for Restricted Assets:

Legally restricted Enterprise Fund cash, investments, and interest receivable balances are reported in a separate Restricted Asset section of the Enterprise Fund statement of position. Such amounts need not be physically segregated from other Enterprise Fund assets, however, unless co-mingling is specifically legally prohibited.

Public utilities customarily require customers to make deposits at the time of connection to the utility system. These deposits are designed to insure payment of final service billings and to protect the utility against damage to equipment located on the customer's property. When a customer withdraws from the system, this deposit is refunded less the amount of any charges outstanding against the account.

Customer deposits held by a utility are still owned by its customers. Customer deposits are classified as restricted assets and reported separately as such on the Enterprise Fund statement of position. Amounts so reported are offset by a current liability (Customer Deposits Payable from Restricted Assets).

Accounting for activities related to revenue bonds typically requires the establishment of restricted assets accounts:

Revenue Bond Construction Account
Revenue Bond Current Debt Service Account
Revenue Bond Future Debt Service Reserve Account
Revenue Bond Contingency (Renewal and Replacement) Account

Revenue bond indentures often refer to these accounts as "funds." However, they are merely mandatory asset segregations and not funds in the sense of fiscal and accounting entities with self-balancing sets of accounts. Whenever possible, they should be referred to as accounts rather than funds to minimize any potential for misleading inference on the part of financial report users.

Revenue bond proceeds earmarked for Enterprise Fund capital asset construction must be accounted for in a Revenue Bond Construction Account. Disbursements for authorized construction purposes are made from this account until the bond proceeds are exhausted. Bond indentures or other legal provisions typically specify the appropriate disposition of any excess of bond proceeds over total authorized construction expenditures.

Most revenue bond indentures restrict certain bond proceeds and/or Enterprise Fund net operating revenues (usually defined as total operating revenues less total operating expenses exclusive of depreciation and bond interest) to revenue bond debt service purposes. Monies are accumulated in a Revenue Bond Current Debt Service Account each month in an amount equal to one-twelfth of the total principal and interest payments due within the next year. Current debt service payments are made from this account. Current liabilities for revenue bond principal and interest are reported as "liabilities payable from restricted assets" on the Enterprise Fund statement of position.

Additional monies are accumulated over the first 60 months or so after revenue bonds are issued in a Revenue Bond Future Debt Service Reserve Account to pay matured bonds and interest in the event of a deficiency in the Revenue Bond Current Debt Service Account described above. Earmarked portions of bond proceeds may also be accounted for in this account. The total amount to be accumulated in the Revenue Bond Future Debt Service Reserve Account varies from one bond indenture to another, but is usually (a) the maximum annual debt service requirement, (b) the average annual debt service requirement, or (c) a specified sum. Under normal circumstances balances accumulated in this account will not be utilized until the final retirement of the bond issue.

Bond proceeds and/or net operating revenues are also accumulated in a Revenue Bond Contingency (Renewal and Replacement) Account for unforseen operating expenditures of an emergency nature or for renewals and replacements of assets. The total amount to be accumulated in this account varies from bond issue to bond issue.

Amounts that should be accumulated in the Revenue Bond Current Debt Service, Revenue Bond Future Debt Service Reserve, and Revenue Bond Contingency Accounts should be recorded as restricted net position. If amounts accumulated in these accounts are less than what is required, details of the shortage(s) should be disclosed in the notes to the financial statements.

Required amounts for the Revenue Bond Current Debt Service Account are reduced by the amount of current liabilities for revenue bond principal and interest and related fiscal charges.

Any excess of cash and investments accumulated in the Revenue Bond Current Debt Service Account over current liabilities for revenue bond principal and interest is also reported as restricted net position.

Depreciation:

The purpose of depreciation is to distribute the cost or other basis of tangible, capital assets (less salvage value, if any), over the estimated useful life of the asset in a systematic, rational manner.

Three factors are involved in determining annual depreciation charges:

(a) The cost or other basis in the asset which includes installation and other capitalizable incidental expenditures.

(b) Salvage value or the expected amount that can be recovered by disposing an asset at the end of its useful life (frequently referred to as scrap value).

(c) Estimated useful life of the asset in relation to number of years or months, operating units, or units of output.

The simplest and most commonly used method for determining depreciation is the straight-line method. This method incorporates the following formula for determining the depreciation charge:

$D = (C-S)/N$, where D = depreciation charge
C = cost or other basis
S = salvage value
N = estimated useful life

Section V of this manual presents the estimated life for many capital assets commonly found in municipal enterprise operations.